IEPR COMMITTEE WORKSHOP ON
CLEAN COAL TECHNOLOGY AND ELECTRICITY IMPORTS:

Overview of Constitutional Limitations on
Out-of-State Procurement Rules

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Introduction and Summary

The notice for the Clean Coal workshop asks:

> To what degree should procurement decisions for out-of-state electricity consider and/or require mitigation for: emissions of criteria and toxic air pollutants; greenhouse gas emissions; and water and waste impacts?

I've been asked to give a brief overview of the potential limitations that might be imposed on such a procurement scheme by the U.S. Constitution's Commerce Clause. Unfortunately, this is an area of law that various justices of the U.S. Supreme Court have characterized as "cloudy waters," "tangled underbrush," a "quagmire," "hopelessly confused," and "virtually unworkable in application" (see *Camps Newfound/Owatonna, Inc. v. Town of Harrison, Maine*, 520 U.S. 564, 610-612 (1997) – so my opinions should be regarded as somewhat less than authoritative.

In addition, I must caution that the devil is in the details, so while I hope to give some useful general principles today, I must caution that whether any particular procurement criterion would be constitutionally valid would require a careful examination of the exact wording of the criterion.

There are several different ways of implementing procurement criteria. I'll focus on two here, which are suggested by the agenda question quoted above:

(1) specified environmental controls or mitigation: for example, "coal-fired powerplants must be IGCC and use dry cooling," or "coal-fired powerplants must sequester carbon." *Such requirements would probably be constitutionally invalid as discriminatory and as "extraterritorial regulation," even if the*

criteria were applied equally to purchases from both in-state and out-of-state plants. [1]

(2) specified environmental performance criteria (e.g., a plant must emit no more than X (net) tons of CO2 per MWh). *Such requirements would probably be constitutional, if they were applied in a nondiscriminatory manner to in-state and out-of-state powerplants, and if the criteria were reasonably related to potential harms occurring in California.*

Other possibilities include differential rate or tax treatment, which I won't cover.

Discussion Limited to IOUs

This discussion assumes that the various potential requirements would be imposed on investor-owned utilities ("IOUs") by the California Public Utilities Commission ("CPUC"). California currently exerts more regulatory control over IOUs than it does over other entities such as ESPs and municipal utilities. The Legislature could expand CPUC control over procurement decisions by private, non-IOU ESPs (see California Constitution, article XII, section 3); the Legislature could also enact statutory requirements for municipal utility procurement decisions (or authorize a state agency to set such requirements). However, such steps would raise additional legal and policy issues (this is a complicated area), so for simplicity, the context of my discussion will be hypothetical CPUC procurement rules for IOUs.

Is FERC Jurisdiction a Limitation?

Let me quickly dispose of one potential federal limitation on out-of-state procurement rules. In today's electricity market, one must always ask whether the Federal Energy Regulatory Commission ("FERC") has jurisdiction. FERC has jurisdiction over rates for wholesale sales and interstate transmission – but not over a state's choice of generation sources. (16 United States Code sections 824(a), 824(b)(1).) Other aspects of federal law, including the U.S. Constitution, and state law as well, can limit a state's ability to control out-of-state procurement decisions, but FERC's authority under the Federal Power Act is probably not a major concern. However,

[1] Such requirements could, however, be applied to an out-of-state powerplant constructed by a California utility (assuming some reasonable relationship between the requirements and effects in California), because of California's authority to regulate the activities of its own utilities, whether in-state or out-of-state.

other commenters have suggested that the recently-enacted federal energy bill increases FERC authority in ways that could constrain state procurement, so this is an area that deserves further inquiry – although not in my presentation today.

The Commerce Clause – General Principles

The "Commerce Clause" of the United States Constitution provides that "[t]he Congress shall have Power . . . [t]o regulate Commerce . . . among the several States . . . ." (U.S. Constitution, Article I, Section 8, Clause 3.) Although the Clause literally establishes only a Congressional power, the U.S. Supreme Court has long established that the Clause also directly limits the power of the States to discriminate against or unreasonably burden interstate commerce. (*Wyoming v. Oklahoma*, 502 U.S. 437, 454 (1992).) This aspect of the Commerce Clause is often referred to as the "Negative" or "Dormant" Commerce Clause.

It is clear that electricity is a good that travels in interstate commerce, so the Dormant Commerce Clause would apply to California procurement criteria. (See *American Power & Light Company v. Securities and Exchange Commission*, 329 U.S. 90 (1946).)

The Two Dormant Commerce Clause Tests – Strict Scrutiny and Balancing

The courts have divided state actions affecting interstate commerce into two classes, although the line separating the two is fuzzy.

First, where a state action discriminates against out-of-state goods, services, or market participants, it will be struck down unless it "demonstrably" promotes a legitimate state interest and there is no less discriminatory means of achieving that interest. (*Wyoming v. Oklahoma*, 502 U.S. at 454.) Indeed, a "virtually *per se* rule of invalidity" is applied to state actions of simple economic protectionism. (*Philadelphia v. New Jersey*, 437 U.S. 617, 624 (1978).) This is true whether the discrimination appears on the face of a statute or regulation or only in its effects; the courts will examine whether a facially-neutral statute or regulation has a discriminatory motive or purpose. (*Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263, 270 (1984); *Westinghouse Electric Corp. v. Tully*, 466 U.S. 388, 393 (1984).) Note that economic protectionism – favoring in-state market participants over out-of-state participants – is not a legitimate state interest, but protection of public health and safety is. (*New England Power Co. v. New Hampshire*, 455 U.S. 331; *Fort Gratiot Sanitary Landfill v. Michigan Department of Natural Resources*, 504 U.S. 353

(1992).) (Enhancing its citizens' economic welfare is also legitimate state interest – but the state cannot advance that interest at the expense of other states.)

This test applied to discriminatory actions is called "strict scrutiny."

Second, where a state action "regulates evenhandedly to effectuate a legitimate local public interest, and its effects on interstate commerce are only incidental, it will be upheld unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits." (*Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970).) Thus nondiscriminatory action furthering legitimate state concerns will normally be upheld despite "incidental" burdens on interstate commerce. However, "the extent of the burden that will be tolerated will of course depend on the nature of the local interest involved, and on whether it could be promoted as well with a lesser impact on interstate activities." (*Id.*) The flexible and unpredictable nature of the balancing test is demonstrated by the words "incidental," "clearly excessive," "extent of the burden that will be tolerated," and "nature of the local interest."

How a court classifies a state action, and thus which test it applies – "strict scrutiny" or the "balancing test" – is often crucial in determining the outcome of a Dormant Commerce Clause case. For non-facially-discriminatory actions, it is especially hard to determine when the Court will view effects on interstate commerce as "discriminatory" or "incidental." Unfortunately, the Supreme Court has "recognized that there is no 'clear line' separating close cases . . . ." (*Brown-Forman Distillers Corp.*, supra, 476 U.S. at 579). Moreover, even the two tests themselves can be hard to distinguish. Strict scrutiny involves determining whether the state action is "demonstrably justified" by a valid state interest and whether there are means available to promote the interest with less adverse effects on interstate commerce; the balancing test involves determining whether there is a "legitimate" state interest and weighing that interest against burdens on interstate commerce. Obviously, the two tests can overlap in their application.

<u>Examples of "strict scrutiny" rulings</u>

In *City of Philadelphia v. New Jersey*, 437 U.S. 617 (1978), the U.S. Supreme Court invalidated a New Jersey statute that banned the importation from other states of most types of liquid or solid waste for disposal in New Jersey landfills. Because the discrimination was express (in-state waste could be disposed, out-of-state waste could not), the Court applied strict scrutiny. New Jersey claimed that the statute should be upheld because its purpose was not economic protectionism, but rather protection of the health and safety of New Jersey residents. The Court acknowledged that the

states certainly have the authority to enact health and safety legislation, but the Court questioned New Jersey's stated rationale and concluded that there was no reason that out-of-state and in-state waste would affect the residents' health and safety differently. Thus there was no reason for the discrimination other than the out-of-state origin of the product.

The State of Oregon made a more sophisticated attempt to ban out-of-state waste by taxing the disposal, in Oregon facilities, of out-of-state waste at $2.25 per ton while disposal of in-state waste had a tax of only $0.85 per ton. Again, the Court used strict scrutiny to invalidate the facially discriminatory statute. (*Oregon Waste Systems, Inc. v. Department of Environmental Quality of Oregon*, 511 U.S. 93 (1994).)

Conversely, the Supreme Court upheld a Maine statute that prohibited the importation of out-of-state live baitfish. (*Maine v. Taylor*, 477 U.S. 131 (1986).) Obviously, the statute expressly discriminated against interstate commerce, so the Court used strict scrutiny. However, the Court stated that Maine had a legitimate interest, unrelated to economic protectionism, because importing out-of-state baitfish would expose the state's environment to parasites that were not present on in-state baitfish and to nonnative species; both the parasites and the nonnative species would adversely affect Maine's environmental quality. In effect, the Court said that the discrimination was against harmful baitfish – not against out-of-state baitfish. Addressing the second part of the strict scrutiny test, the availability of less discriminatory alternatives, the Court found that there were no valid techniques for inspecting live baitfish to weed out parasites and nonnative species.

The lesson of these cases is that it's crucial to avoid express discrimination or even discrimination in effect. The *Maine v. Taylor* baitfish case appears to be the only case that applied strict scrutiny and still upheld a challenged state action. So if California wants to use a procurement criterion related to environmental quality, it should be expressed in performance terms such as X tons per MWh of a pollutant, and applied to all plants regardless of location or ownership, rather than expressly applying it to powerplants in certain states, or even only to coal-fired powerplants. The reality is that there is virtually no coal or coal-fired generation in California, so any criterion applying only to coal plants could be viewed as discriminatory. Of course, any such criterion would have to be justified in terms of its impacts in California – that is, the state would have to show that there is an adverse effect in California that results from purchasing electricity produced in plants that emit more than X tons per MWh, and that the procurement criterion is reasonably related to reducing or avoiding that adverse impact.

Size Doesn't Matter in Strict Scrutiny Cases; Size Matters in Balancing Test Cases

The Supreme Court overturned an Oklahoma statute that required its utilities to burn at least 10 percent Oklahoma coal in their powerplants. The Court noted that only a relatively small part of the Oklahoma coal market was affected, and an even smaller part of the interstate market, but stated that those facts were irrelevant: the express discrimination against out-of-state coal was by itself sufficient to invalidate the statute. (*Wyoming v. Oklahoma*, 502 U.S. 437, 455-456 (1992).) Therefore, it would not help California to claim that a discriminatory procurement criterion affected only a small part of the California or the interstate market. However, the size of market effects is usually an important consideration in balancing test cases (see p. 4 above, discussing "the extent of the burden that will be tolerated" under the balancing test).

Examples of Balancing Test Rulings

An Arizona statute forbade the transport, whether intrastate or interstate, of cantaloupes that were not packed in specified ways. The statute's purpose was to preserve the reputation of Arizona growers by preventing the shipment of inferior or deceptively packaged produce. Before the statute was enacted, a grower shipped its cantaloupes into California for packing. The grower contended that it would have to spend $200,000 to construct a packing facility in Arizona. The Court held that by interfering with the ability of the grower to ship unpackaged cantaloupes to California, there was a burden on interstate commerce that was clearly excessive in relation to Arizona's interest. (*Pike v. Bruce Church, Inc.*, 397 U.S. 137 (1970.)

Frankly, this case is puzzling to me; indeed, the Court hinted that it was actually applying strict scrutiny because the statute could be seen as simply requiring that various business operations be conducted in-state, which would subject it to strict scrutiny. But puzzling or not, the case is important because it demonstrates that even under the "balancing test," the Court may overturn state action despite its nondiscriminatory character. The case is also important because crucial to the Court's decision was its characterization of the state's interest, in preserving its growers' reputation, as minimal. State action with the avowed, and actual, effects of protecting the state's environment, and its citizens' health, would be viewed as more substantial – although still potentially struck down if burdens on interstate commerce clearly outweighed the state's interest.

In contrast to the Arizona cantaloupe case is one in which the Supreme Court upheld a Minnesota statute that banned the retail sale of milk in nonreturnable plastic containers. (*Minnesota v. Clover Leaf Creamery Company,* 449 U.S. 456 (1981).)

The Court stated that Minnesota had a legitimate interest in resource and energy conservation. It is also stated that the burdens on interstate commerce were not excessive in relation to the state's interest, even though there was a disparate impact in-state and out-of-state: the banned plastic was produced entirely out-of-state and the raw material for allowed paperboard containers was produced mainly in-state. The Court found the burdens to be minimal because milk in other containers could still be shipped across the state's borders, because most milk producers already used several different kinds of containers, and because out-of-state firms making allowable containers would gain some new business.

There are two main lessons of the *Pike* and *Clover Leaf* cases. First, the balancing test is very flexible and the outcome of cases using it is hard to predict. Second, the courts will carefully and in great detail examine the state interest served by an action (and the rationale for that interest), as well as the effects on in-state and out-of state entities. Thus before California imposes procurement requirements affecting out-of-state entities, it should undertake its own careful assessment, involving both in-state and out-of-state parties, to develop a record to show that it has legitimate interests that are served by procurement criteria, and to ensure that any burdens on interstate commerce are as small as possible and are outweighed by the state's interest. This is so whether the actions are taken by the Legislature, by the CPUC, or by some other entity.

Extraterritorial Regulation

Another crucial legal principle stemming from the Dormant Commerce Clause, as well as from due process limits on state authority, is that states do not have extraterritorial jurisdiction: that is, they cannot attempt to regulate activities outside of their borders. (*Healy v. Beer Institute*, 491 U.S. 324, 336 (1989); *Shaffer v. Heitner*, 433 U.S. 186, 197 (1977).) Thus California would have to be sure that procurement criteria were expressed in terms of what *California* entities – electricity purchasers – can and cannot do. (California can, however, regulate out-of-state activities of its utilities if those activities affect California ratepayers; thus the CPUC can require environmental controls on powerplants built out-of-state by California utilities, if there is a legitimate, California-related reason to do so.)

What Would Justice Roberts Do?

It is no secret that the membership of the Supreme Court often affects its decisions; this is certainly true in Dormant Commerce Clause cases, which often produce

dissenting opinions. Recently, Justice Sandra Day O'Connor announced her retirement and President Bush nominated Judge John Roberts of the District of Columbia Court of Appeals to take her place. Where the Court has struck down state enactments on Dormant Commerce Clause grounds, Justice O'Connor has usually voted with the majority, while Chief Justice Rehnquist and Justices Scalia and Thomas have more often voted to uphold state action – sometimes even questioning the entire analytic basis of Dormant Commerce Clause principles. (See *West Lynn Creamery v. Healy*, 512 U.S. 186, 209-210, 216-17 (1994).) Thus one might predict that with Justice O'Connor's replacement the Court would be more inclined to find challenged state actions constitutional. However, I was unable to find any relevant opinions authored by Judge Roberts during his brief tenure on the D.C. Court, so I can't predict what he might do. Moreover, given the notorious failure of some Supreme Court justices to live up to the "advance billing" of their supporters or opponents, it would be very shortsighted to predict any major changes in the Court's Commerce Clause jurisprudence as a result of Justice O'Connor's retirement, regardless of who replaces her.

Now, back to the topic at hand.

Bottom Line – What Should California Do?

1. Do not attempt to impose direct requirements for out-of-state environmental controls or mitigation. They would be almost certainly be unconstitutional.

2. Make sure that the courts will use the balancing test, not strict scrutiny, by avoiding both facial discrimination, and discrimination in practice. In particular:

   Procurement criteria should be expressed in terms of environmental performance standards, not "Wyoming coal" (expressly discriminatory), or even in relation to "coal-fired powerplants" because of the large disparity between California and other states in terms of both coal deposits and coal-fired generation.

   Procurement criteria should apply equally to in-state and out-of-state generation.

   Procurement criteria should be established at a level that does not obviously discriminate against out-of-state production (for example, a

pounds-per-kWh standard that no out-of-state coal plant could meet, but that every in-state natural gas plant could meet).

3. Establish the state's legitimate interest(s) in the procurement criteria. Carefully, thoroughly, and in detail establish the relationship between the emissions (or another impact) of out-of-state (and in-state) facilities from which power might be procured, and the environmental, health, or economic impacts in California, in order to justify a criterion related to that impact.

   Environmental Impacts. It might be easier to establish a relationship between distant CO2 emissions and impacts in California, because emissions of CO2 and other greenhouse gases have worldwide impact, which obviously extends to California; by contrast, other air emissions impacts, such as those from criteria and toxic pollutants, or the impacts of water use or waste disposal might have a regional implications but not extend into California. I am not trying to say that a procurement criterion based on CO2 is or is not more likely to withstand a constitutional challenge than a different criterion; the point here is that whatever criterion is established must not only be evenhandedly applied, but must also have a reasonable relation to impacts in California.

   Economic Implications of Environmental Impacts. The environmental characteristics of plants chosen for procurement can have economic consequences in the future. For example, Congress could impose various controls or taxes on coal plants, such as CO2 sequestration or a CO2 tax, and it could be legitimate for California to act now to try to avoid its citizens having to pay such costs in the future. Or lack of water in the West, or severe controls on its use, could prevent a powerplant from meeting its sales obligations to a California utility. It could be reasonable to impose procurement criteria designed to protect against such contingencies. In a different legal context, the Supreme Court allowed California to take account of the potential future economic costs of nuclear waste disposal. The Court upheld, against a federal preemption challenge, the California laws requiring the Energy Commission to find that there was an adequate permanent waste disposal method, before nuclear construction could take place, because of the potential costs of power if such a method were not available. (PG&E v. State Energy Resources Conservation and Development Commission, 461 U.S. 190 (1983).) Of course, any attempt to base procurement criteria on such future costs should also have a carefully-thought-out and carefully-justified rationale.

The necessity for a careful assessment of California's interests and the ways they would be served by procurement criteria applies no matter who is establishing the criteria: the Legislature, the CPUC, another agency, etc.

4. Carefully assess the economic effects on in-state and out-of-state actors, balance potential adverse effects on interstate commerce against the benefits to the state, and show that the benefits outweigh any adverse effects.